SBI RESEARCH

Accelerated Rate Cuts to upend the shifting Contours of Credit-Deposits Wedge

The benign inflationary patterns suggest an aggressive rate cut trajectory by India's Central Bank with key Policy rate likely to breach the Neutral rate by March'26 though the transmission of rate cuts on Deposits may not be even… Cumulative rate cuts of ~125-150 bps estimated in FY26 in the best case scenario with inflation to breach 3% consistently for next 3 months barring any food price shock /heatwave …. Jumbo rate cuts of 50 bps could be a better signalling mechanism… Credit-Deposit wedge may aggravate as deposit rates bow down with lacklustre growth while OMOs and a buoyant dividend transfer to ensure no negative surprises on liquidity front and better yield management …yields to move closer to 6% with a downward bias

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Executive Summary….1/2

- The sharp moderation in CPI inflation, hitting a 67-month low of 3.34% in Mar'25 due to sharp correction in food inflation bodes well for lowering the average CPI headline forecast for FY26 below 4% now **(with below 3% in Q1FY26)….** Nominal GDP growth is expected to be in the range of 9-9.5% for FY26 (Budget: 10%), signifying a Goldilocks period to slash the policy rates given the low growth and low inflation

- With multi-year low inflation in March and benign inflation expectations going forward, **we expect rate cuts of 75 basis points in June and August (H1) and another 50 bps cut in H2 i.e. cumulative cuts of 125 bps going forward** while 25 bps rate cut has already been initiated in Feb'25 (that could put the terminal Rate at ~5.0%-5.25% by March 2026). However, we feel, jumbo cuts of 50 bps, could be more effective than secular 25 bps tranches spread over the horizon

- In response to the 50-bps cut in the policy repo rate since February 2025, banks have reduced their repo-linked EBLRs by a similar magnitude. While the MCLR, which has a longer reset period and is referenced to the cost of funds, may get adjusted with some lag. Larger transmission to deposits rates is expected in the coming quarters

- Based on the available estimates of natural rate, the neutral nominal policy rates works out at 5.65%.... The current trajectory of the domestic inflation is well within the band of 2-6% with average inflation based on available data placed at 4.7%. Thus, there is 70 bps distance before target convergence despite the tolerance…. The potential output growth is estimated at 7% and based on the advance estimates GDP growth of 6.3% and worst GDP growth at 6%, the output gap is in the range -100 to -70 bps…. Assuming further convergence of domestic inflation to target, the possibility of cumulative rate cut of 125-150 bps is also possible by March 2026…implying repo rate declining below neutral rate

- Given the dual mandate, the Fed may hold rates in next two cycles…. A pause signal is unequivocal based on recent statements

- **We expect the USD/INR pair to stabilize in the range ₹85-87 for 2025.... The domestic impact of tariffs on dollar will be visible in 2025 which will support rupee…Further, DXY is expected to fall as US domestic economy will adjust to tariff impact**

Executive Summary….2/2

- Accelerated and Unabated series of OMOs showcase RBI's willingness to go the Extra Mile even as massive OMOs by RBI fortify the ecosystem though appearing counter intuitive to collective market wisdom at times…. RBI conducts OMO auction for an overall quantum without security specific limits and retains flexibility to provide allotment to a maximum number of participants. Typically, amount accepted is always spread among the securities so that any/one aggressive bidder may not corner the liquidity window

- Auctions have also been held in some liquid, on the run papers - probably an attempt to provide liquidity to Banks who do not run a large, longer duration HTM portfolio

- The present move, through OMOs scheduled for another Rs 1.25 lakh cr in May'25, looks aligned to keep liquidity in surplus to the tune of ~Rs. 2 lakh crore+ as announced by the Governor in the last policy meet, more so factoring in the recent volatility in the markets and outlook on anchoring durable growth while negating any impact of exogenous shocks' pass through… Also the maturing Short Forwards position, initiated to cushion the rupee from undue volatility against a masquerading Greenback early this year and relentless sell-off by FIIs, now necessitates RBI to put in place countermeasures

- OMOs are also expected to build moats around yields…. Yields may remain capped due to replenishment demand from banks that have offloaded securities in recent OMOs, balancing any spillover from heightened conflict post Pahalgam terror attack

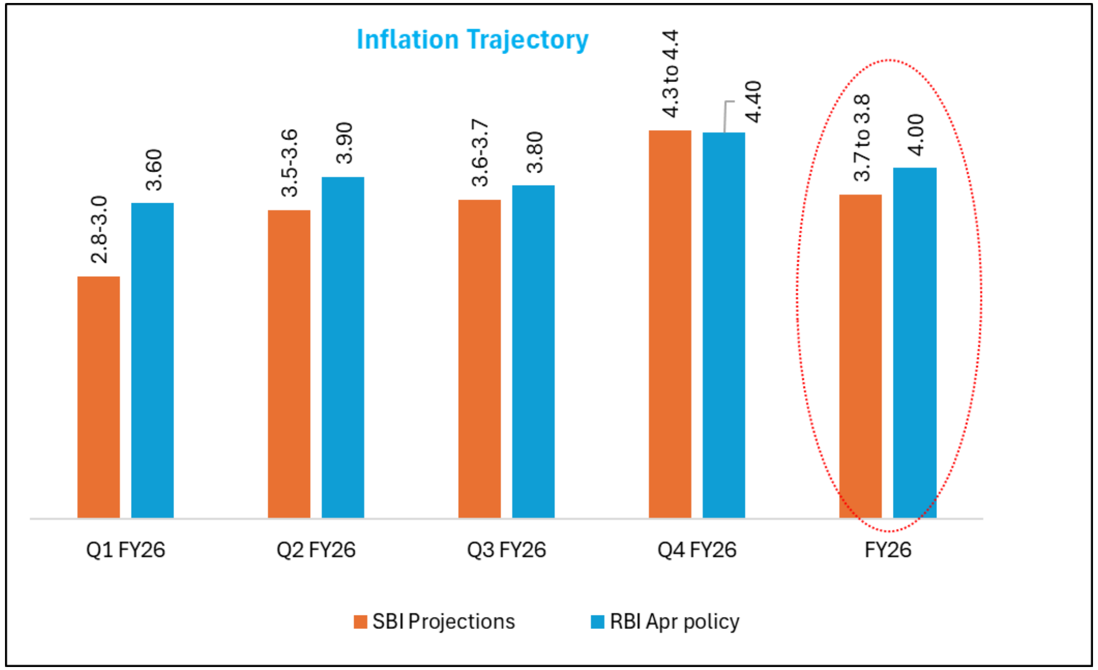
- With close to ~Rs. 4 lakh crore of OMO done and another Rs. 1.25 lakh crore (or more!) pending, G-Sec holding by banks as a % of SLR portfolio is on the decline. Moreover, larger holding by the regulator, at times, tends to affect secondary market liquidity…RBI dividend could top Rs 2 lakh crores

- With rapid transmission of rate cuts desired, deposit rates would come under immediate downward pressure, ensuring deposits mobilisation remain a Herculean challenge for Banks…. While Credit growth is expected to moderate at 11-12% for FY26, Deposits may stop shy of double digit growth during the FY accentuating a wedge between Credit-Deposits momentum, squeezing the NIM of banks adversely

- Assuming the % share of ownership is same as that of Sep'24, with slight increase in FPI's share, the minimum gap to be filled comes to ~Rs 1.7 lakh Crores in FY26…. OMOs in SDLs may be considered going forward to bring more balance to the market and align RBI holding to the proportion of outstanding G-Secs and SDLs… Also, the huge number of outstanding SDL securities (~5000 against ~100-Plus for Central Government) may be rationalized through Buy back

Inflation Trajectory: Below 3%in Q1FY26…to stay below 3% till June….

- India's CPI inflation moderated to 67-month low of 3.34% in Mar'25 due to sharp correction in food inflation, We believe average CPI headline forecast could stay below 4% till December 2025 and FY26 average may be 3.7-3.8%, unless there is any food price related shock
- Core inflation (CPI ex food & fuel) edged up from a low of 3.28% in August 2024 to 3.77% in October and remained steady around 3.6 - 3.7% during November 2024-January 2025. In February and March 2025, core inflation picked-up to 4.1% – the highest print in 15 months – driven primarily by a sharp increase in gold prices, a safe heaven amidst the global tumult. **By excluding gold from core inflation, core CPI ex Gold has remained below both core and overall CPI numbers. Core inflation is at 3.2% excluding Gold. We expect core inflation will in the range of 4.0-4.3% in FY26**
- Subsequently, the nominal GDP growth is expected to be in the range of 9-9.5% for FY26 (Budget: 10%). Given the low growth and low inflation, it is the Goldilocks period to slash the policy rates



Neutral rates suggest cumulative rate cut up to 100 bps in FY26…Repo rate to go below neutral rate

- Based on the available estimates of natural rate the neutral nominal policy rates works out at 5.65%
- The current trajectory of the domestic inflation is well within the band of 2-6% with average inflation based on available data at 4.7%. Thus, there is 70 bps distance before target convergence despite the tolerance
- The potential output growth is estimated at 7% and based on the advance estimates GDP growth of 6.3% and worst GDP growth at 6%, the output gap is in the range -100 to -70 bps
    - IMF and S&P have reduced GDP growth outlook marginally to 6.3%
- Assuming further convergence of domestic inflation to target, the possibility of cumulative rate cut of 125-150 bps is also possible by March 2026…implying repo rate declining below neutral rate

Transmission of Policy Rate….Expect ~ 100 bps cut in deposit rate

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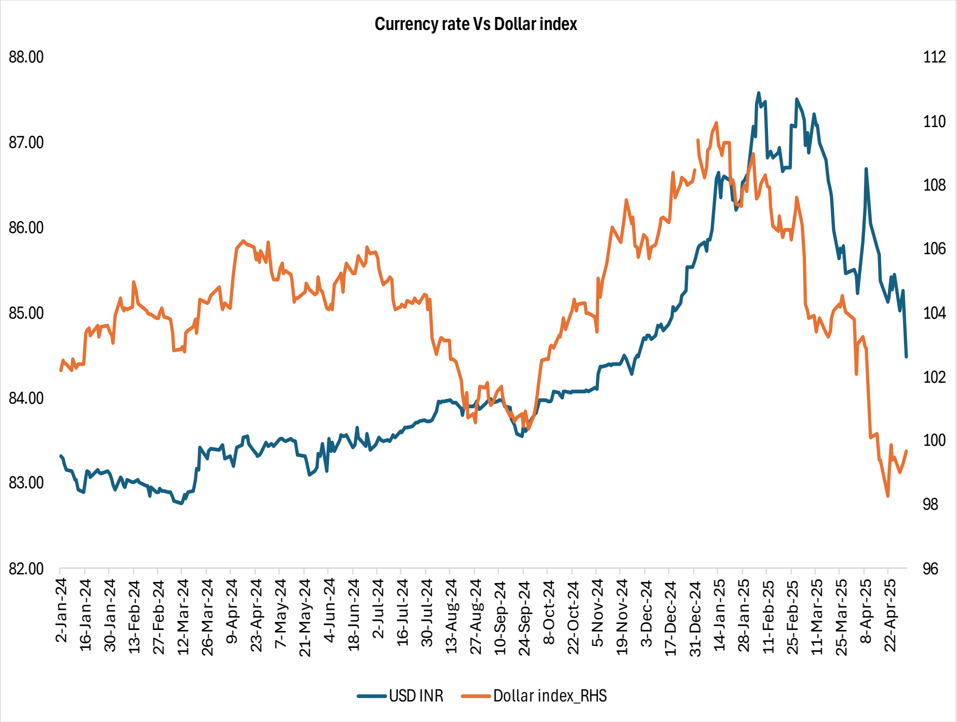
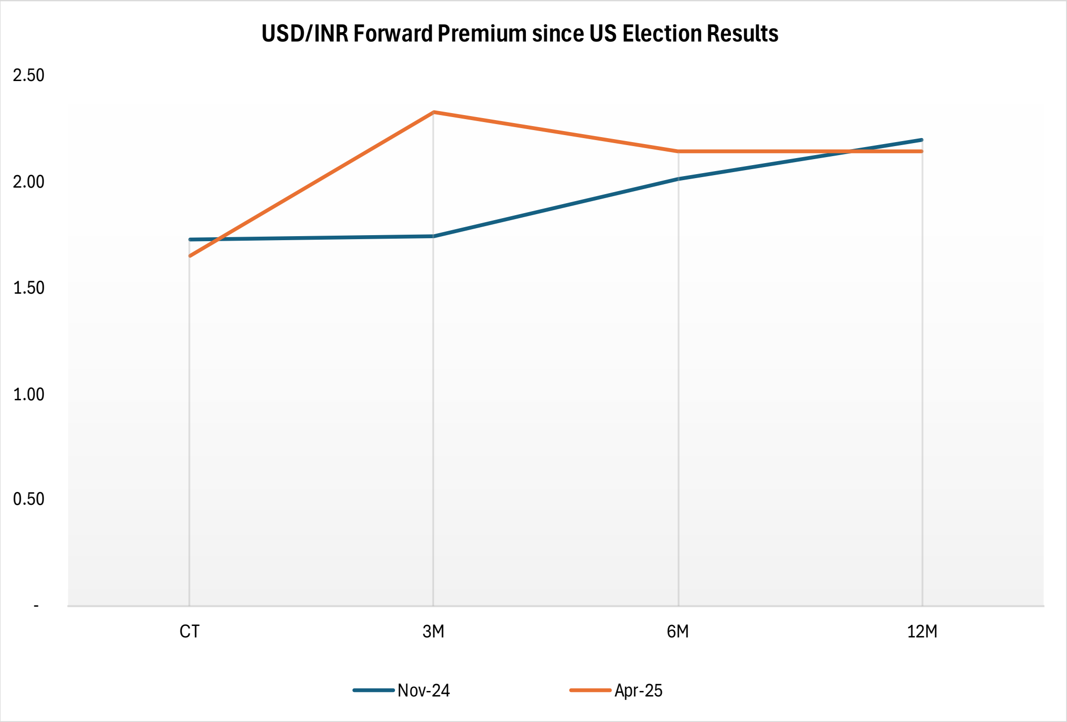
- In response to the 250 bps increase in the policy repo rate since May 2022 till Jan'2025 banks have revised their repo linked external benchmark-based lending rates (EBLRs) up by a similar magnitude. The 1-year MCLRs of SCBs rose by 175 bps during May 2022 to January 2025. The weighted average lending rate (WALR) on fresh and outstanding rupee loans increased by 181 bps and 113 bps, respectively, during the same period. On the deposit side, the weighted average domestic term deposit rates (WADTDRs) on fresh and outstanding deposits increased by 253 bps and 199 bps, respectively, during the same period
- In response to the 50-bps cut in the policy repo rate since February 2025, banks have reduced their repo-linked EBLRs by a similar magnitude. While the MCLR, which has a longer reset period and is referenced to the cost of funds, may get adjusted with some lag. Transmission to deposits rates is expected in the coming quarters….**we expect ~100 bps cut in bank deposits rates from current levels**

Transmission to Banks' Deposit and Lending Rates (Variation in basis points)

	Period	Repo Rate	Term Deposit Rates		Lending Rates			
			WADTDR_Fresh Deposits	WADTDR_Outstanding Deposits	EBLR	1-Yr. MCLR (Median)	WALR_Fresh Rupee Loans	WALR_Outstanding Rupee Loans
Easing Phase	Jan'19 to Apr'22	-250	-	-188	-	-155	-244	-152
Tightening Phase	May'22 to Jan'25	250	253	199	250	175	181	113
Easing Phase	Feb'25	-25	-8	2	-50	0	-5	-10
	Apr'25	-25						

USD/INR outlook: Rangebound ₹85-87 in 2025





- We expect the USD/INR pair to stabilize in the range ₹85-87 for 2025.
- The domestic impact of tariffs on dollar will be visible in 2025 which will support rupee
- DXY is expected to fall US domestic economy adjust to tariff impact.
- May 2026 USD/INR NDF is factoring a rate of ₹85.87 ~ ₹86 per dollar over 12M horizon

Tariffs and Fed rate outlook

- The annual US inflation continues to ease and reached 2.4% in March 2025

- The US nonfarm payroll employment rose by 177,000 in April, while the unemployment rate remained unchanged at 4.2 percent

- The impact of tariff on US inflation is yet to show up and the successive incoming data can have higher readings. A sharp rise in short-term inflation expectations is possible

- Given the Fed's dual mandate, the Fed may hold rates in next two cycles

- A pause signal is unequivocal based on recent statements

RBI's steady dividend trajectory amidst evolving liquidity conditions…

- We employ **ARIMA (AutoRegressive Integrated Moving Average)** forecasting model to predict future trends for Dividend payments by RBI to GOI for FY25. ARIMA is used to capture the temporal dependencies and structural trends embedded in the series. Moreover, dividends exhibit both persistence and sensitivity. ARIMA equation is given by

$$y_{t} = \theta + \alpha_0 y_{t-1} + \alpha 1 y_{t-1} + \cdots + \alpha_P y_{t-p} + \beta_1 e_{t-1} + \ldots\ldots + \beta_P e_{t-p} + vt$$

Where yt is the 1st difference of dividend payout by RBI

- The results from the ARIMA forecasting model suggest that the **RBI's dividend payouts are expected to be Rs 2.18 lakh crore** in FY25 following a steady, trend over the next fiscal. The forecasted value show a potential increase in the dividend payout for FY 2025, driven by the current economic conditions and monetary policies dynamics being implemented by the RBI.

- RBI's ongoing **forex interventions**, particularly in response to the global economic uncertainty, are pivotal in shaping the future of its dividend payouts. As the central bank continues to stabilize the rupee by purchasing foreign currencies, the resulting **liquidity boost** could **significantly improve the RBI's financial position, contributing to higher profitability and larger dividend payouts in FY 2025**

- Given the challenging global environment and the RBI's proactive role in managing external shocks, the anticipated increase in dividend payouts aligns with the central bank's broader economic interventions, positioning the RBI as a critical financial contributor to the government's fiscal resources.

Accelerated OMOs showcase RBI's willingness to go the Extra Mile…..

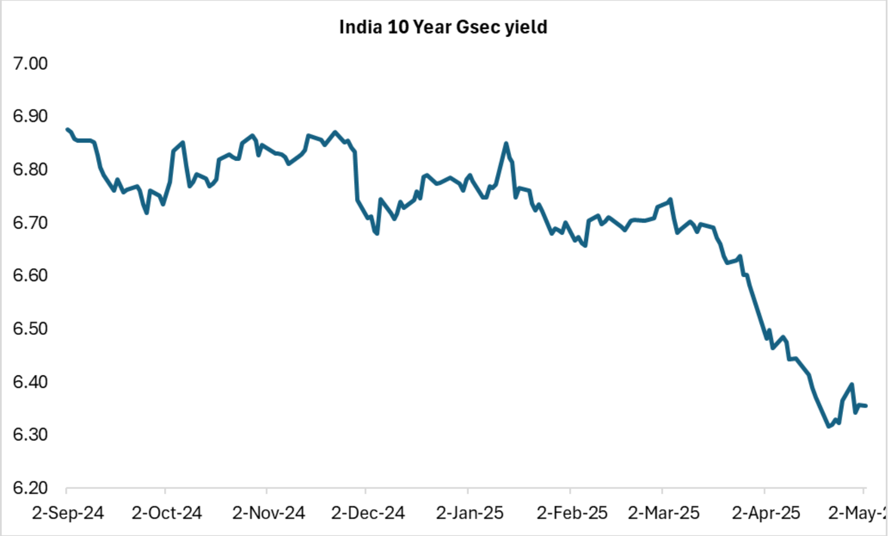
- RBI conducts OMO auction for an overall quantum without security specific limits and retains flexibility to provide allotment to a maximum number of participants. Typically, amount accepted is always spread among the securities so that any/one aggressive bidder may not corner the liquidity window

- Auctions were also held in some liquid, on the run papers - probably an attempt to provide liquidity to Banks who do not run a large, longer duration HTM portfolio

- OMOs, among other tools were deployed to inject liquidity to the tune of Rs. 8 lakh crore (including VRRs of Rs. 1.83 lakh crore beyond 14 days, which has since matured), with another round of Rs. 1.25 lakh crore scheduled for May 2025 in 4 tranches

OMO purchase in Rs cr

Tenure of Securities	Jan- Mar'25		Apr'25	
	Amount accepted	% share	Amount accepted	% share
upto Years	25754	10.5	10076	8.4
> 5 to < 10 yrs	86364	35.3	69118	57.6
10 yrs	43893	17.9	11674	9.7
> 10 yrs, < 15 yrs	88550	36.2	29132	24.3
Total	**244561**	**100.0**	**120000**	**100.0**



Massive OMOs by RBI counter intuitive to collective market wisdom but fortifies the ecosystem….

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- As system liquidity has remained in surplus since end-March, the latest round of OMOs has caught the broader markets somewhat off the guard. However, the move looks aligned to keep liquidity in surplus to the tune of Rs. 2 lakh crore+ as announced by the Governor in the last policy meet, more so factoring in the recent volatility in the markets and outlook on anchoring durable growth while negating any impact of exogenous shocks' pass through

- Also the maturing Short Forwards position, initiated to cushion the rupee from undue volatility against a masquerading Greenback early this year and relentless sell-off by FIIs, now necessitates RBI to put in place countermeasures to ensure sufficient liquidity is available for frictionless operations within the ecosystem… Latest RBI numbers put the overall short Forwards close to US$64 Bn (March'25), with $12 Bn each under 1-Month and 1-3 Months bands but a lot will depend on outright spot purchases that may make the entire exercise liquidity neutral

- OMOs are also expected to build moats around yields…. Yields may remain capped due to replenishment demand from banks that have offloaded securities

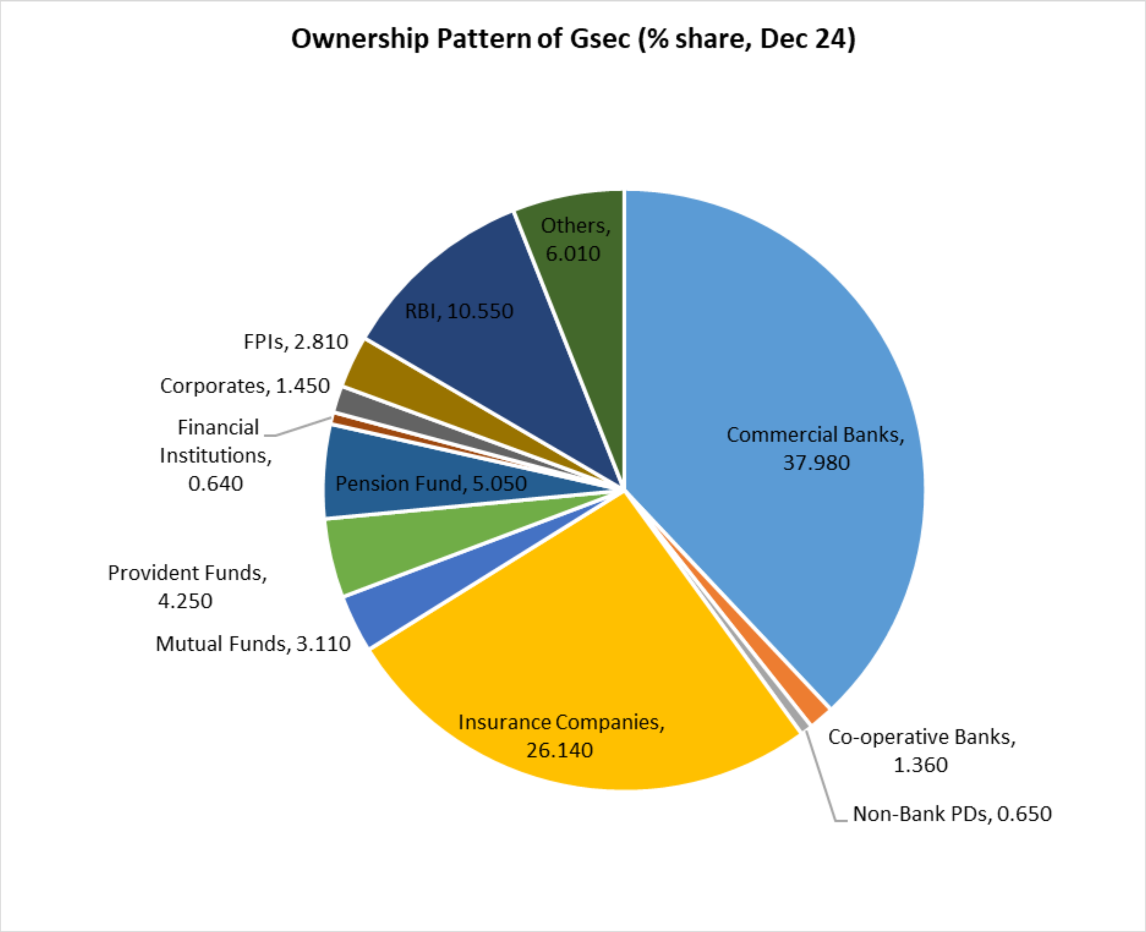
- With close to Rs. 4 lakh crore of OMO done and another Rs. 1.25 lakh crore (or more!) pending, G-Sec holding by banks as a % of SLR portfolio is on the decline. It remains to be seen how such OMOs may impact secondary market liquidity, if any

- **With rapid transmission of rate cuts desired, deposit rates would come under immediate downward pressure, ensuring deposits mobilisation remain a Herculean challenge for Banks…. While Credit growth is expected to moderate at 11-12% for FY26, Deposits may stop shy of Double digit growth during the FY accentuating a wedge between Credit-Deposits momentum, squeezing the NIM of banks adversely**

- OMOs in SDLs may be considered going forward to bring more balance to the market and align RBI holding to the proportion of outstanding G-Secs and SDLs…. **Also, the huge number of outstanding SDL securities (~5000 against ~100-Plus for Central Government) may be rationalized through Buy back / Re-issuance which not just increases the underlying liquidity of such bonds in the secondary markets (apart from consolidation through lessening fragmentation), but also reduces the cost of issuance for the issuer**

With an unchanged ownership in G-sec in FY26, OMO gap in FY26 at Rs 1.7 trillion…RBI is doing Rs 2.45 trillion in Apr-May

- Assuming the % share of ownership is same as that of Sep’24, with slight increase in FPI’s, the minimum gap to be filled is Rs 1.66 lakh Crores.



SLR Demand - Supply (Rs cr)	
	FY26
Demand from Banks	6,59,174
Demand from non-Bank PDs	15,231
Demand from PFs	2,05,614
Demand from Insurance cos	4,72,151
Demand from MFs	59,019
FPI Demand	34,269
Demand from Co-op banks	38,077
Demand from others	1,04,711
Financial institutions	22,846
Corporates	38,077
Pension fund	87,576
Total Demand from various players	17,36,744
Total Supply(Net borrowing from central and states)	19,03,834
Minimum Gap to be filled (through RBI OMO Purchases)	**1,67,090**

Financial results indicate banks' resilience

- The profitability of banks across most jurisdictions showed mixed movements in response to higher interest rates in FY24. However, the benign interest rate environment is expected to bolster banks profitably during FY25
- In India, profitability of banks is expected to improve for the seventh consecutive year in FY25. Both PSBs and PVBs exhibited an increase in net profit and return on assets (RoA) in FY25 (so far financial results of eight banks released)
- Despite higher profits and lower NPAs, the interest margin of banks shrunk, though marginally, in Q4 FY25. Additionally, the JIT mechanism adversely impacting the float of funds of banks (RBI' 2025) we believe that this will also impact the margins negatively…

Banks' Financial Results

Bank	Net profit (Rs crore)			Deposits Growth FY25 (% YoY)	Credit Growth FY25 (% YoY)	Gross NPA		RoA		NIM	
	FY24	FY25	% YoY			FY24	FY25	FY24	FY25	Q4 FY24	Q4 FY25
ICICI Bank	40888	47226	15.5	14.0	13.3	2.16	1.67	2.37	2.41	4.40	4.41
HDFC Bank	60812	67347	10.7	14.1	5.4	1.24	1.33	1.98	1.91	3.40	3.50
Axis	24861	26373	6.1	9.8	7.8	1.43	1.28	1.83	1.74	4.16	4.08
Yes bank	1251	2406	92.3	6.8	8.1	1.70	1.60	0.30	0.60	2.40	2.50
Total 4 Pvt. Banks	**127813**	**143353**	**12.2**	**12.8**	**7.9**	**1.63**	**1.47**	**1.62**	**1.67**	**3.40**	**3.47**
SBI	61077	70901	16.1	9.5	12.0	2.24	1.82	1.04	1.10	3.30	3.00
BoM	4055	5520	36.1	13.4	17.8	1.88	1.74	1.50	1.75	3.97	4.01
CBI	2549	3785	48.5	7.2	15.2	4.50	3.18	0.63	0.86	3.58	3.17
IOB	2656	3335	25.6	9.1	14.2	3.10	2.14	0.81	0.92	3.73	3.77
Total 4 PSBs	**70337**	**83541**	**18.8**	**9.5**	**12.6**	**2.93**	**2.22**	**1.00**	**1.16**	**3.65**	**3.49**

Source: SBI Research

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